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No. 92-854

In the Supreme Court of the United States

OCTOBER TERM, 1992

CENTRAL BANK OF DENVER, N.A.

Petitioner,

v.

FIRST INTERSTATE BANK OF DENVER, N.A., AND JACK K. NABER,

Respondents

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether, by virtue of compliance with the terms of a trust indenture, a trustee who aids and abets a scheme to defraud is exempted from accountability under the federal securities laws?

2. Whether, under the Securities Exchange Act of 1934, recklessness may satisfy the scienter requirement for aiding and abetting where the defendant actively assists the primary wrongdoing?

RULE 29.1 LIST

A. PARENT COMPANIES

First Interstate Bank of Denver, N.A. is wholly owned by First Interstate Bancorp of Colorado, which is wholly owned by First Interstate Bancorp of Los Angeles.

B. SUBSIDIARIES (EXCEPT WHOLLY OWNED SUBSIDIARIES)

First Interstate Bank of Denver, N.A., owns 75 percent of the shares of PMP, Inc.

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BRIEF FOR RESPONDENTS IN OPPOSITION

First Interstate Bank of Denver, N.A., ("First Interstate") and Jack K. Naber[1] respectfully oppose the request of Central Bank of Denver, N.A., ("Central Bank" or "Central") that this Court issue a writ of certiorari to review part of the unanimous decision of the United States Court of Appeals for the Tenth Circuit entered on July 8, 1992, and reported as *First Interstate Bank of Denver, N.A., v. Pring*, 969 F.2d 891 (10th Cir. 1992).

STATEMENT OF THE CASE

Central Bank acted as indenture trustee in an $11 million bond issue offered by the developer of the Stetson Hills project in Colorado Springs. In June 1988, First Interstate purchased $2.1 million of the Stetson bonds and resold some of them to its customers. First Interstate had also invested in the developer's earlier offering in 1986, a $15 million issue. A central covenant of both bond offerings was a so-called "160% test," the unqualified, and highly marketable, promise of the Stetson Hills

[1] Mr. Naber, a customer of First Interstate, was initially proposed as a class action representative. When the federal district court declined to certify a class, Mr. Naber continued in the action as an individual plaintiff.

developer that the bonds would continuously be secured by property worth at least 160% of the outstanding bond principal, and that if the value of the collateral were to fall below 160% the developer would add more property to the lien. These assurances proved fraudulently false.

In early April 1989, only ten months after the 1988 Stetson issue was sold, Central Bank sent letters to all Stetson bondholders, announcing that both issues were in default. The lead underwriter for the 1988 bonds then revealed for the first time that far from satisfying the 160% test, the bond collateral was worth substantially less than the bond principal. The facts developed through informal and formal discovery in the litigation showed that the 1988 bonds had been issued and marketed by means of a fraudulent scheme of the developer, aided by Central Bank, calculated to assure that fatal deficiencies of the bond collateral would be kept hidden from investors until well after the bonds were sold. Central Bank's role in that scheme was pivotal.

As trustee of the 1988 Stetson bonds, Central was obligated under the bond covenants to obtain an appraisal report on the proposed collateral, reflecting compliance with the 160% test. Central was also required to select an appraiser. In early January 1988, an appraisal prepared by Joseph Hastings was presented to Central. The Bank trust officer who reviewed the appraisal noticed that the property valuations which Hastings had arrived at were purportedly no different from the valuations determined by him in 1986, despite an intervening history of declining real estate values in Colorado Springs. Shortly thereafter, the same Central Bank trust officer received a letter from Dain Bosworth, Inc., the lead underwriter of the 1986 Stetson bonds, warning that the critical 160% test was "probably not being met" as to the collateral for the 1986 bonds, and that the Hastings appraisal was "suspect and should not be relied on without further independent check."[2]

The Central Bank trust officer then had Central's own in-house expert review the appraisal for the 1988 bonds. On March 22, 1988, Central wrote a letter to the Stetson developer, summarizing obviously serious deficiencies in Hastings's appraisal and demanding that an independent

[2] In the trial court, First Interstate identified as one of its experts an experienced appraiser of real estate development properties, Mr. James Burbach. Mr. Burbach had appraised the collateral for the 1988 bonds as of the same date used in the Hastings appraisal, and had employed the correct methodology, required by the bond covenants. Burbach's work showed that the Hastings appraisal was inflated by approximately 400 percent.

review be conducted by a different appraiser. In the letter, Central Bank said:

> . . . . Based upon our review, and the recommendation given us by [in-house appraiser] Mr. Elmer, we will require, in our capacity as Trustee, that an independent review of the appraisal be conducted by a different appraiser . . .
>
> We are requiring that an independent review of the appraisal be conducted for the following reasons:
>
> 1. The age of the comparable sales data makes it of questionable use as a valid basis for valuation. We question why more recent sales were not utilized for this purpose.
>
> 2. Mr. Hastings has confirmed that his discounting methods did not consider a bulk sale and a forced liquidation context, as is specifically required by the Indenture.
>
> 3. Based on our review and investigation, the values determined by the appraisal appear to be unjustifiably optimistic, given the current economic conditions in the residential and commercial real estate markets in El Paso County.

(Emphasis added).

Only nine days after Central's trust officer "required" an independent review, her superior, a Bank vice-president, took over responsibility for the transaction. Central then met with the Stetson Hills developer and entered into a concealed side-agreement by which any review of Hastings's "unjustifiably optimistic" appraisal would be postponed until December 1988. The bonds were to be sold to the public in June 1988. The factual circumstances in this case, where a trust officer initially decided to require an independent review, but then a Bank vice-president made a deal with the developer to put off the review until after the bonds were marketed, were unprecedented at Central Bank.

In June 1988, First Interstate and other investors bought the 1988 Stetson bonds ignorant of Central's agreement with the developer and of the multiple deficiencies described in Central's March 22 letter. Only six months later, when an independent appraiser finally evaluated the collateral for the 1988 bonds, the risks concealed by Central Bank's side agreement with the developer materialized, along with substantial losses to First Interstate and to hundreds of other Stetson bondholders.

First Interstate's Complaint alleged that Central Bank should be held accountable as an aider and a bettor under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (1988), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1989).

In the federal district court, First Interstate argued that even under a test of conscious intention to defraud, the facts before the court reflected conduct for which Central Bank's liability could not be precluded by summary judgment. The Tenth Circuit's opinion reviewed the factual background in detail. The court unanimously held that in the face of evidence that Central Bank actively assisted a scheme to delay review of the criticized Hastings appraisal, recklessness would satisfy the scienter requirement. 969 F.2d at 902-04. The court left open the issue of Central Bank's actual knowledge of the fraud, which would supply an alternative ground for a finding of the necessary "scienter." 969 F.2d at 904 n.19.

Central Bank filed a petition for rehearing, making arguments essentially identical to those contained in its Petition in this Court. On August 18, 1992, the petition for rehearing was denied, without dissent.

ARGUMENT

I. THE TRUST INDENTURE ACT EXPRESSLY PRESERVES AN INDENTURE TRUSTEE'S LIABILITY UNDER THE FEDERAL SECURITIES LAWS; CENTRAL BANK SHOWS NO PERSUASIVE LEGAL REASON WHY PERFORMANCE OF ITS CONTRACT WITH A WRONGDOING ISSUER SHOULD PROVIDE IMMUNITY FOR FRAUD

Section 326 of the Trust Indenture Act of 1939 (the "Indenture Act" or the "Act") states that "[e]xcept as otherwise expressly provided, nothing in this title shall affect . . . the rights, obligations, duties or liabilities of any person under [the Securities Act of 1933, or the Securities Exchange Act of 1934 or the Public Utility Holding Company Act of 1935]." 15 U.S.C. § 77zzz (1988). Citing this provision, the Tenth Circuit held that Central Bank may be liable for aiding and abetting a securities fraud even if it performed all of its contractual duties under the trust indenture. *First Interstate Bank v. Pring*, 969 F.2d 891, 901 (10th Cir. 1992). Central Bank seeks review of this part of the Tenth Circuit's decision, contending that if it performed its duties under the indenture, it should, because of that contractual compliance, be beyond the reach of the anti-fraud provisions of the federal securities laws. (Petition, pp. 6-9). This position is contradicted by the Indenture Act and by existing case law. For the

reasons stated below, respondent First Interstate submits that the Tenth Circuit was correct.

First, the operative statute is clear and unambiguous. The plaintiffs sued the indenture trustee as an aider and abettor of a securities fraud. Under section 326 of the Indenture Act, an indenture trustee is not immune from federal securities liability unless the Act specifically so provides. In this case, the Act provides for no such exemption.

Second, Central Bank fails even to mention the operative section of the Act under which the Tenth Circuit decided the issue. By not explaining how the Tenth Circuit may be said to have incorrectly construed section 326 of the Act, Central Bank offers no meaningful basis for review.

Third, Central Bank has already conceded in its own brief to the Tenth Circuit that, "Plaintiffs correctly point out that the Act does not affect 'the rights, obligations, duties and liabilities of any person' under the federal securities laws." Answer Brief of Defendant-Appellee Central Bank at 29 (quoting 15 U.S.C. § 77zzz). Having taken this position (on which the Tenth Circuit expressly relied, see 969 F.2d at 901), Central Bank may not now persuasively argue a contrary position. *See Hormel v.Helvering*, 312 U.S. 552, 556-57 (1941).

Fourth, Central Bank misapplies section 315 of the Act, under which the indenture is deemed to include a provision that "the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture." 15 U.S.C. § 77ooo(a)(l) (1988). This provision limits the indenture trustee's affirmative duties arising from the indenture. It cannot reasonably be construed to immunize the indenture trustee from liability for actively assisting the fraudulent securities scheme at issue in this case. Congress emphasized this distinction by enacting section 326, which states that the Act does not affect liability under the federal securities laws.[3]

Fifth, existing law squarely supports the Tenth Circuit's decision. See *Cronin v. Midwestern Okla. Dev. Auth.*, 619 F.2d 856, 861-62 (l0th Cir. 1980); *Lewis v. Marine Midland Grace Trust Co. of New York*, 63 F.R.D. 39, 45-46 (S.D.N.Y. 1973); *Ross v. Bank South N.A.*, 837 F.2d 980, 1003 (llth Cir. 1988). Central Bank cites no persuasive authority to support its theory of contractual immunity from liability under the securities statutes.

[3] Even if section 326 and section 315 may be said somehow to "conflict" with each other, fundamental rules of statutory construction require the same result. Section 326 of the Act, which specifically states that the Act does not alter liability under the federal securities laws, prevails over the less specific provision in section 315 that an indenture trustee shall only be liable for performance of duties specifically set forth in the indenture. D. Ginsberg & Sons, Inc. v. Popkin, 285 U.S. 204, 208 (1932) ("Specific terms prevail over the general in the same or another statute which otherwise might be controlling.").

Central Bank relies heavily on the Second Circuit's opinion in *Elliot Assoc . v. J. Henry Schroder Bank & Trust Co.*, 838 F.2d 66, 71 (2d Cir. 1988).[4] (Petition at 6). In *Elliot*, the Second Circuit never addressed section 326 of the Indenture Act because the debenture holders failed to allege a violation of the Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (1988), or the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (1988). Rather, the debenture holders in Elliot asserted "that the trustee was under a duty—implied from the indenture, the [Indenture] Act or state law—" to act beyond the express terms of the indenture. *Id.* at 70. These facts, materially different from those which confronted the Tenth Circuit in this case, place the claims in Elliot well outside the scope of section 326.

II. STRAINING TO DISCERN A "CONFLICT," CENTRAL BANK MISCHARACTERIZES THE TENTH CIRCUIT AS FOLLOWING A RULE THAT RECKLESSNESS IS THE UNIFORM STANDARD FOR SCIENTER; IN FACT THE TENTH CIRCUIT MUCH MORE NARROWLY HOLDS, CONSISTENT WITH WELL-REASONED PRECEDENT, THAT RECKLESSNESS MAY SATISFY THE SCIENTER REQUIREMENT WHERE THE AIDER AND ABETTOR ACTIVELY ASSISTS THE FRAUD

The Tenth Circuit held that either knowing or reckless conduct may provide the basis for liability where the aider and abettor takes affirmative action which assists the primary wrongdoing.[5] 969 F.2d at 902-03. Specifically, after discussing relevant authority, the Court said:

> The cases discussed above reject the idea that the scienter element for aiding and abetting liability cannot be satisfied by recklessness without a duty to disclose. We also reject that view. We hold that in an aiding and abetting case based on

[4] Central also purports to rely upon *Lorenz v. CSX Corp.*, 736 F. Supp. 650, 658 (W.D. Pa. 1990), but there the federal district court did not address section 326 of the Act. (Petition at 6-7).

[5] Based on this finding, the Tenth Circuit did not reach plaintiffs' alternative argument that a material factual issue also exists concerning Central Bank's actual knowledge of the primary violation. 969 F.2d at 904 n.l9. Central does not dispute that upon remand, this alternative ground of its liability would, in any event, remain to be decided.

> assistance by action, the scienter element is satisfied by recklessness.

969F.2d at 903 (emphasis supplied). First Interstate submits that under the particular facts of this case the Tenth Circuit was correct, and that its decision represents no conflict with prior precedent.

In cases where liability is premised on silence or inaction, the federal courts have generally agreed that recklessness will not establish scienter unless the aider or abettor has a "duty to disclose" the primary violation. *See, e.g., Woodward v. Metro Bank of Dallas,* 522 F.2d 84, 97 (5th Cir. 1975). Central Bank argues that the same rule should be extended to cases like this one, where the aider and abettor actively assists the primary violation. However, the factual settings and the holdings of many of the purported "majority" cases that Central Bank cites do not support its contention. *See IIT v. Cornfeld,* 619 F.2d 909, 922-25 (2d Cir. 1980) (involving "mere inaction" by aider and abettor); *Cleary v. Perfectune, Inc.,* 700 F.2d 774, 776-78 (lst Cir. 1983) ("The inaction and silence of the defendants is the sole basis on which the plaintiffs attempt to ground the defendants' aiding and abetting liability."); *Abell v. Potomac Ins. Co.,* 858 F.2d 1104, 1127 (5th Cir. 1988) ("[Fifth Circuit precedent] establishes a single test for scienter that varies as the level of assistance decreases on a sliding scale from recklessness to 'conscious intent.'"), *cert. denied,* 492 U.S. 918 (1989), *and vacated on other arounds sub nom. Fryar v. Abell,* 492 U.S. 914 (1989); *Woods v. Barnett Bank of Fort Lauderdale,* 765 F.2d 1004, 1010 (llth Cir. 1985) (following Fifth Circuit's "sliding scale" test). The holdings of these cases, as opposed to Central Bank's characterization of them, do not conflict with what Central strives to recast as a "minority" rule of the D.C., Eighth,[6] Ninth, and now, Tenth Circuits that in some circumstances affirmative aiding and abetting may be actionable if accompanied by a reckless state of mind.

Central Bank also mischaracterizes the Ninth and Tenth Circuits as "effectively establish[ing] recklessness as the universal standard for scienter." (Petition at 12). In the Ninth Circuit case where Central says that

[6] The Eighth Circuit has followed the Fifth Circuit's "sliding scale" test. *See FDIC v. First Interstate Bank of Des Moines, N.A.,* 885 F.2d 423, 430 (8th Cir. 1989) (Under the Fifth Circuit rule, "the intent requirement becomes greater as the activity in question is more remote"). If there had been doubt about the Fifth Circuit's position, it was very recently clarified by *Akin v. Q-L Investments Inc.,* 959 F.2d 521 (5th Cir. 1992), which states that "an accountant may be held liable for recklessly aiding and abetting a primary violation . . . *when his assistance in the fraud is particularly substantial and unusual or when he owes some special duty of disclosure." Id.* at 526 (emphasis added).

the federal appellate court "drops the pretense of the duty to disclose requirement altogether" (Petition at 13), the Ninth Circuit in fact quite carefully limited its ruling to a situation involving active assistance. *Levine v. Diamanthuset, Inc.,* 950 F.2d 1478, 1484 n.4, 1485 n.5 (9th Cir. 1991). Concerning an alleged active aider and abettor, the Ninth Circuit. stated:

> [W]e do not discuss the [aider and abettor's duty to disclose] because [its] aiding and abetting liability is premised in part not on silence, but on actual misrepresentations. . . . [I]t may be necessary to revisit the question of [the aider and abettor]'s duty to disclose if aiding and abetting liability is ultimately to be premised only on the appearance of [the aider and abettor]'s name in [the issuer]'s promotional materials.

Id. at 1485 n.4.

The Tenth Circuit could also have reversed based on Central Bank's actual knowledge, an issue which remains for disposition in the trial court. On the facts of this case, the Tenth Circuit's decision was correct.

CONCLUSION

Central Bank's Petition fails to address the controlling law properly relied upon by the Tenth Circuit and mischaracterizes the Tenth Circuit's opinion in order to suggest a reviewable conflict with other circuits. Petitioner has shown no fundamental respect in which the decision of the United States Court of Appeals or the method of decision of that Court, either requires reversal or merits review. The Petition should be denied.

Respectfully submitted this 16th day of December 1992.

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